

The Federal Tax Gap

Statement of Chris Edwards, Director of Tax Policy Studies, Cato Institute

before the
House Budget Committee

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Mr. Chairman and members of the committee, thank you for inviting me to testify today regarding the “tax gap,” which is the difference between the amount of taxes owed and the amount of taxes actually paid.

The net tax gap, after enforcement, is \$290 billion, or 14 percent of what is owed, according to the Internal Revenue Service.¹ Put another way, compliance with the federal tax system stands at 86 percent. I think to most people, that compliance rate would sound quite high. After all, we rarely get 100 percent compliance with any law. Consider automobile seatbelt laws. The national compliance rate with seatbelt laws was 81 percent in 2006, and that is despite large education campaigns on that issue.²

International evidence also suggests that the federal tax compliance rate is high. Friedrich Schneider, a professor of economics at Johannes Kepler University in Austria, completed a detailed study last year on the size of underground, or shadow, economies in 145 countries.³ He is perhaps the world’s top expert on underground economies and tax evasion. Schneider defines the shadow economy to include legal activities that are not reported to governments in order to avoid taxes and regulations. Reviewing the literature, he finds that “in almost all studies, it has been found that the tax and social security contributions are one of the main causes for the existence of the shadow economy.”⁴

Schneider finds that the shadow economies of developing countries are much larger than those of the advanced nations of the Organization for Economic Cooperation and Development. Looking at 21 OECD nations in 2002, he found that the average size of shadow economies was 16 percent of gross domestic product. The United States had the smallest shadow economy at just 8 percent of GDP, according to Schneider’s analysis.

In a study for the International Monetary Fund in 2000, Schneider similarly found that the United States had a smaller shadow economy than nearly all other countries.⁵ In sum, Americans seem to be highly law-abiding when it comes to government taxes and regulations.

Another factor to consider is that the size of the federal tax gap does not seem to have increased over the years. The Government Accountability Office noted recently that “the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades.”⁶ Thus, to the extent that the tax gap is a problem, it is not getting any bigger.

For these reasons, the intense focus in Congress on the tax gap in recent months is perplexing. Americans should pay the amount of taxes that they owe, but the tax gap is far down on a long list of problems with the federal tax system. Congress should focus on the following items as more pressing problems needing attention:⁷

- America’s high-rate and uncompetitive corporate income tax, which is a growing concern in our increasingly globalized economy.
- The excessive taxation of savings and investment under the income tax, which reduces the growth rate of the U.S. economy.
- High marginal tax rates on individuals and businesses, which are a hurdle to productive activities and encourage unproductive avoidance activities.
- The enormous complexity of the tax code. The number of pages of federal tax law and regulations increased from 40,500 in 1995 to 66,498 by 2006.⁸
- Increasing horizontal inequity in the tax code. The plethora of deductions and credits added in recent years creates unfairness by imposing different tax burdens on people with similar incomes.
- The alternative minimum tax, which threatens to hit 30 million taxpayers by the end of the decade if not reformed or repealed.

Americans have a responsibility to pay all the taxes that they owe. But Congress has a responsibility to make sure that laws are as simple as possible and easy to comply with. With the tax code, Congress is utterly failing in its responsibility. James Madison noted that “it will be of little avail to the people that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood ... or undergo such incessant changes that no man who knows what the law is today can guess what it will be tomorrow.”⁹

Let’s make the tax code coherent first before we consider any additional regulatory actions to close the tax gap. Focusing on the tax gap first puts the cart before the horse. Let’s reform the code to increase economic efficiency and fairness, and an important byproduct will be to increase tax code compliance.

Observations on the Tax Gap Estimates

Most of the tax gap regards individual taxes, not corporate taxes. IRS data shows that the corporate tax gap is only 9 percent of the overall gap.¹⁰ Yet concerns are often expressed about supposed rampant corporate tax abuse. In recent remarks about the tax gap, Senator Kent Conrad (D-ND) talked about the “hemorrhaging” of federal tax revenues from cheating by large multinationals with offices in the Cayman Islands.¹¹

However, the problem on the corporate side is legal tax avoidance by multinationals due to our high corporate tax rate, not illegal tax evasion. Interestingly, the Joint Committee on Taxation report on Enron found hundreds of Enron subsidiaries in the Caymans, but the JCT had a hard time showing that the firm's tax machinations were actually illegal.¹² The corporate tax code encourages the creation of very complex corporate tax structures that are usually legal, but they do make tax compliance much more difficult.

Note that corporate tax revenues have soared in recent years. Corporate tax revenues are expected to be \$342 billion in fiscal 2007, which is up a remarkable 65 percent over the peak at the end of the last boom in fiscal 2000 of \$207 billion.¹³ Corporate tax revenues are clearly not "hemorrhaging."

The tax gap related to the estate tax is also worth looking at. At \$8 billion, the tax gap for the estate tax is a huge 29 percent of the \$28 billion in estate tax revenues in 2001. This large gap indicates the large inefficiency of the estate tax, which probably drives relatively more tax avoidance and evasion than any other federal tax. This is one reason why many tax experts support repeal of this tax.

The federal FICA payroll tax has a very low tax gap of just \$14 billion. Experts note that the FICA tax has a low tax gap because of employer withholding. But another factor that promotes high compliance is that the payroll tax is the simplest federal tax. It has a low, flat rate and no deductions. It is a model to consider for reforms of the federal income tax. Indeed, the Hall-Rabushka flat tax for individuals would consist simply of a flat-rate payroll tax, and thus would likely have a high compliance rate.

Major tax reforms would reduce the tax gap by reducing taxpayer confusion and aggressive tax planning. Many taxpayers pay the wrong tax amount because they are confused about what income is taxable and what tax breaks are allowed. And since complex tax rules are subject to multiple interpretations, they spur taxpayers to take risks on tax strategies in the hope that they are not caught by the IRS. The Joint Committee on Taxation noted that "taxpayers may consciously choose to 'play the audit lottery' by taking a questionable position on their tax returns, in the belief that complexity will shield them from discovery."¹⁴ In its report on Enron, the JCT concluded that the company "excelled at making complexity an ally."¹⁵

The IRS estimate of the tax gap includes \$32 billion related to claiming the wrong amounts of credits and deductions. The number of such "tax expenditures" has soared in recent years. Indeed, the GAO found that the number of tax expenditures has more than doubled since 1975.¹⁶ Table 1 shows the number of tax expenditures relating to energy and education have more than doubled since 1995. The explosion of tax credits and deductions has added complexity and increased the system's unfairness by promoting horizontal inequities.

Table 1. Rising Tax Complexity

Item	Initial Year	Recent Year
a. Total pages of federal tax rules (code, regulations, IRS rulings)	<u>1995</u> 40,500	<u>2006</u> 66,498
b. Federal income tax compliance costs	<u>1995</u> \$112 billion	<u>2005</u> \$265 billion
c. Number of IRS tax forms	<u>2000</u> 475	<u>2006</u> 582
d. Percent of tax filers using paid tax preparers	<u>1995</u> 50%	<u>2005</u> 61%
e. Pages in Form 1040 instruction book	<u>1995</u> 84	<u>2005</u> 142
f. Number of income tax breaks for education	<u>1995</u> 7	<u>2006</u> 16
g. Number of income tax breaks for energy	<u>1995</u> 11	<u>2006</u> 26
h. Hours Americans spend on tax compliance	<u>1995</u> 5.3 billion	<u>2005</u> 6.4 billion
i. H&R Block revenues from U.S. tax preparation	<u>1996</u> \$740 million	<u>2005</u> \$2.2 billion

Sources: Chris Edwards, based on CCH (a), Tax Foundation (b), IRS (c, d, e), Office of Management and Budget (f, g, h), H&R Block (i).

The largest source of the tax gap is the small business and self-employed sector of the economy. It is this sector that would bear the burden of many proposed actions to reduce the tax gap, as it would have to pay higher taxes and deal with greater paperwork. If Congress and the IRS increased reporting requirements and tax regulations to try and reduce the tax gap, most of the added compliance burden would fall on law-abiding businesses that are already paying their full load of taxes.

Note that individuals and businesses already spend more than 6 billion hours—or more than 3 million person-years—complying with federal taxes. Many members of Congress, usually around April 15, decry that large burden. Yet trying to reduce the tax gap by imposing added paperwork on businesses would increase the time spent on unproductive compliance activities.

Note that small businesses already have a higher ratio of tax compliance burdens to taxes collected than do large businesses. For small businesses, tax compliance costs can be larger than actual taxes paid.¹⁷ The IRS Taxpayer Advocate has found that the heavy compliance burden on small businesses is one of the most serious problems with the tax system.¹⁸ Thus, targeting small businesses with more regulations to try and close the tax gap seems especially unfair.

Senator Kent Conrad (D-ND) recently stated that “closing the tax gap is not about raising taxes on anyone.”¹⁹ But in fact, it is. Certainly, some individuals and businesses are currently not paying all they owe. But taking actions to increase taxes paid would create all the usual “deadweight losses,” or inefficiency costs, that any tax increase would

create. If a small business is required to pay more tax, it will have less cash flow available for capital investment and hiring workers. There is no free money sitting around for the federal government to simply grab without negative side-effects on the economy.

Conclusion

In conclusion, the great attention being placed on the tax gap seems out of place given that the problem is not excessive compared to other countries, nor is it getting worse over time. Federal revenues are up above historical norms at 18.5 percent of GDP in fiscal 2007. Indeed, data for the first four months of fiscal 2007 show a 10 percent increase over fiscal 2006.²⁰

The fiscal problem in Washington is not a lack of revenue. Thus burdening small businesses and the economy with more tax regulations to try and close the tax gap is the wrong way to go. In his classic work, *The Wealth of Nations*, Adam Smith recognized that the total cost of taxation is “a great deal more” than just the amount of revenue collected. For one thing, he argued that “by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression.”

Rather than increase odious tax-gathering activities, we should instead reform the tax code to reduce marginal rates and eliminate special preferences. That would be beneficial for families and the economy, and it would have the side effect of reducing the tax gap.

Thank you for holding these important hearings. I look forward to working with the committee on tax issues, particularly tax code simplification and reform.

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¹ The IRS estimates are discussed in Government Accountability Office, “Tax Compliance,” GAO-07-391T, January 23, 2007. See also U.S. Department of Treasury, “A Comprehensive Strategy for Reducing the Tax Gap,” September 26, 2006.

² National Highway Traffic Safety Administration, “Seat Belt Use in 2006: Overall Results,” November 2006, www-nrd.nhtsa.dot.gov/nrd-30/NCSA/RNotes/2006/810677.pdf.

³ “Shadow Economies of 145 Countries all over the World: What do we really know?” May 2006, www.econ.jku.at/Schneider/ShadEconomyWorld145_2006.pdf.

⁴ “Shadow Economies of 145 Countries all over the World: What do we really know?” May 2006, p. 5, www.econ.jku.at/Schneider/ShadEconomyWorld145_2006.pdf.

⁵ Friedrich Schneider and Dominik Enste, “Shadow Economies Around the World: Size, Causes, and Consequences,” International Monetary Fund, Working Paper 00/26, February 2000.

⁶ Government Accountability Office, “Tax Compliance,” GAO-06-1000T, July 26, 2006, p. 1.

⁷ For a discussion of problems with the tax code, see Chris Edwards, "Options for Tax Reform," Cato Institute Policy Analysis no. 536, February 24, 2005, www.cato.org/pub_display.php?pub_id=3681.

⁸ Based on the page count of the CCH *Standard Federal Tax Reporter*. See Chris Edwards, "Income Tax Rife with Complexity and Inefficiency," Cato Institute Tax & Budget Bulletin no. 33, April 2006, www.cato.org/pubs/tbb/tbb-0604-33.pdf.

⁹ James Madison, *The Federalist Papers*, No. 62.

¹⁰ For all tax gap figures, see Government Accountability Office, "Tax Compliance," GAO-07-391T, January 23, 2007. See also U.S. Department of Treasury, "A Comprehensive Strategy for Reducing the Tax Gap," September 26, 2006.

¹¹ Senator Kent Conrad (D-ND), Remarks at a Senate Budget Committee "Hearing on President Bush's FY2008 Budget Proposals on Tax Compliance," February 14, 2007.

¹² In testifying on the Enron activities, then JCT chief of staff, Lindy Paull, said, "I don't know if you could call it illegal." See Peter Behr, "Enron Skirted Taxes Via Executive Pay Plan," *Washington Post*, February 14, 2003, p. E1.

¹³ *Budget of the U.S. Government, FY2008, Historical Tables*, p. 30.

¹⁴ Joint Committee on Taxation, "Study of the Overall State of the Federal Tax System," JCS-3-01, April 2001, volume 1, p. 102.

¹⁵ Joint Committee on Taxation, "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," volume 1: Report, JCS-3-03, February 2003, p. 16.

¹⁶ Government Accountability Office, "Tax Compliance," GAO-06-1000T, July 26, 2006, p. 7.

¹⁷ Art Hall, "Compliance Costs of Alternative Tax Systems II," Tax Foundation, March 1996.

¹⁸ Internal Revenue Service, National Taxpayer Advocate, *Annual Report to Congress, FY 1999*.

¹⁹ Senator Kent Conrad (D-ND), Remarks at Senate Budget Committee "Hearing on President Bush's FY2008 Budget Proposals on Tax Compliance," February 14, 2007.

²⁰ Congressional Budget Office, "Monthly Budget Review," February 6, 2007.